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# **A New Approach to Designing a Political Risk Assessment Survey in International Firms in the Context of Czech International Firms**

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## **ABSTRACT**

This paper seeks to resolve a conceptual dilemma in the field of political risk assessment in firms' international business activities in the context of the Czech Republic. Exploratory interviews were conducted which were designed on basis of a solid body of literature on political risk, international business, political risk assessment, risk management and assessment, and enterprise risk management. The results obtained via these interviews suggest that this PRA function is almost non-existent in Czech international firms, i.e. suggest that findings of previous studies do not apply. Since previous studies of PRA identified a PRA function in the majority of firms involved in international business the results of the exploratory research suggest a novel and different approach needs to be adopted in order to analyse the nature of treatment of host-country political risk in Czech-specific context, and the factors influencing the choice whether or not to adopt a PRA function.

# **A New Approach to Designing a Political Risk Assessment Survey in International Firms in the Context of Czech International Firms**

## **INTRODUCTION**

Any firm is a subject to various risks stemming from its internal or external environment. One of the risks which have been agreed as probably the most harmful one for a firm, should it arise, is political risk (Kobrin 1981; Haksoon 2010). Al Khattab et al. (2008) pointed out that the political risk increases with international involvement of companies in countries with political risks which may or may not vary from those of their home country environment. Since the economic downturn in 2007 has been marked with new threats and uncertainties to international businesses, the need for studying political risk and its assessment became even greater than four decades ago when political risk assessment was introduced in the academic literature (MIGA 2009).

The rationale behind and the importance of PRA is supported by the risk – uncertainty argument which justifies the importance of assessing political risk as it consequently decreases potential material and income losses by transforming uncertainty, which is immeasurable in its nature, to risk which can provide more specific information on the impact of an event on firm's activities. Since the majority of studies aimed at political risk assessment have been conducted in developed countries (e.g. Rice and Mahmoud (1990), Hashmi and Guvenli (1992), Pahud De Mortanges and Allers (1996), Demirbag and Gunes (2000), and Hood and Nawaz (2004) in Canada, U.S., Netherlands, Turkey and U.K. respectively) there is a substantial body of literature explaining how firms from developed countries assess and manage political risk; however, there is a great gap in the literature on political risk assessment in international firms from other economies. As a result this research seeks to analyse political risk management behaviour in Czech international companies with a special reference to the political risk assessment function and its relationship with various mitigation strategies.

Given the specific characteristic and past development of the Czech economy, it is crucial to provide a rationale for the choice of the sample. It has been suggested by Golshan and Rasid (2012) and Al Khattab et al. (2008) that companies from developed countries are more likely to adopt a PRA function i.e. carry out the PRA regularly. Since the Czech Republic can be considered as a fully developed economy, it should – according to the studies of Stapenhurst (1992), Wyper (1995), Pahud De Mortanges and Allers (1996), Jenney (2001) and Kettis

(2004) – embody a relatively fair standard of political risk assessment function in international firms. However, based on exploratory interviews conducted in Czech international companies, the PRA function is almost non-existent. Given that this result is supported by a number of interviews where some of the Czech MNCs were included, this result is particularly alarming, and therefore requires a special treatment of studies aimed at PRA function in this region.

Given the importance of the influence of political risk on firms while undertaking international business and the underrepresentation of countries from this region in the field of PRA, it is desirable to establish a concept explaining the low standard of political risk assessment in Czech international firms. Since the history of the Czech economy is similar to other countries in this region, this approach is also expected to be applicable to at least the ‘Visegrad Four’ economies.

## **LITERATURE REVIEW**

Risk in the context of any business studies is a commonly studied variable. In the international business context, risk is magnified as there are various host-country risks complementing the home-country firms face whether or not they expand outside their home countries. Of all the risks firms face in host-countries, political risk is probably the most important one (Kobrin 1981; Stapenhurst 1992; Haksoo 2010). The reason for considering political risk as one of the risks which would cause greatest harm to firms should it occur is given by the nature of political risk; i.e. it is difficult to anticipate and once an event has occurred it is very often irreversible and the time and effort a firm has to make in order to restore the original conditions is often very timely and costly. However, as Stapenhurst (1992) and Pahud De Mortanges and Allers (1996) highlighted, political risk can be divided into various groups and consequently quantified. This can be done by means of analysis which is commonly known as political risk assessment (PRA).

Given the stage of this research the structure will be different from the usual structure of a literature review. Firstly the theoretical concept and the rationale behind political risk and its assessment will be discussed followed by justification of this type of study in the context of Czech international firms. The following sections will discuss the traditional methodology and survey design in PRA studies, and changes to the original idea of PRA with special focus on causes of the low standard of political risk assessment. These two methodologies (classical

survey vs. Czech-specific survey) will be complemented by discussion of the exploratory interviews into PRA practices of Czech international firms.

### Political Risk and Political Risk Assessment

The definition of political risk has been around in international business circles for many years. It is very common that political risk would either overlap with if not included in a country risk (e.g. Guerin and Manzocchi 2009; Haksoon 2010; Krifa-Schneider and Matei 2010; Palacios and Griffin 2011; Jimenez 2011; Meon and Sekkat 2012; Vadlamannati 2012). However, as pointed out by Al Khattab et al. (2008), there is a distinction between these two risks and as such political risk should be treated independently from the other country risks. Country risk is usually referred to as a combination of all cultural, social, political and economic risks comprising the country-specific economic environment. Political risk has a direct link to government actions (or inactions) and/or adverse actions aimed against a government (Howell 2001; Nawaz and Hood 2005; Inkster 2008).

Since these political risks would inevitably cause threats to profitability and also non-material losses, the researchers who conducted studies in this field commonly agree on PR being of concern to firm management and therefore the firms are generally expected to incorporate an assessment function of potential political risks to their activities. Regardless of the PRA function being described as largely informal, subjective, unsystematic, reactive, and inadequate; the majority of researchers have concluded that such an analysis of political risk help firms to decrease the potential losses which they face (Blank et al. 1980; Kobrin et al. 1980; Kobrin 1981; Kobrin 1982; Hashmi and Baker 1988; Rice and Mahmoud 1990; Stapenhurst 1992; Wyper 1995; Pahud De Mortanges and Allers 1996; Burmester 2000; Hood and Nawaz 2004; Al Khattab et al. 2008).

Political risk assessment (PRA) is the process of analysing political business activities which has been suggested to be one risk management activities. As suggested by Blank et al. (1980), Kobrin (1981), Hashmi and Baker (1988), Rice and Mahmoud (1990), Stapenhurst (1992), Wyper (1995), Burmester (2000), Hood and Nawaz (2004) or Al Khattab et al. (2008); the fact that the majority of studies of PRA report a low standard of PRA indicates either a lack of awareness of political risk in business participants or resistance by firms to the notion that PR is amenable to analysis. Since the theory suggests that a firm can benefit from adopting a PRA function in its activities, it is desirable to explain the generally low standard of PRA in international firms.

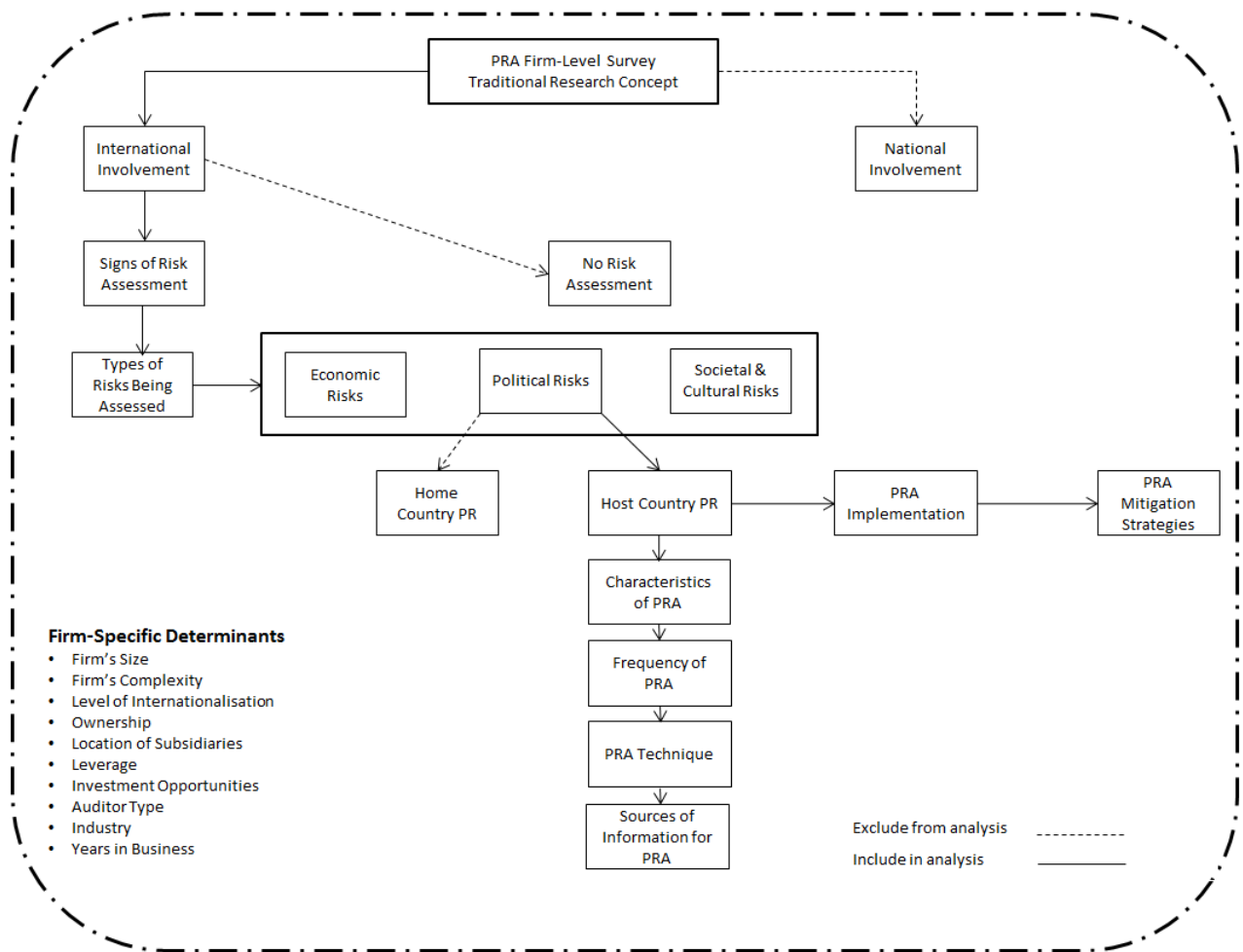
### Political Risk Assessment in Czech International Firms

As already mentioned, political risk assessment has been conducted mainly in international firms from developed countries. Although the Czech Republic is a country which can be considered as a developed one in terms of economic indicators and the general business environment, there are variations in the country characteristics compared to other countries in which PRA studies are usually conducted. The specific post-socialist transition market context that gives very distinct characteristics mainly to managerial culture in these countries might cause different approach to and assessment techniques of political risk in firms' international business activities (Wieners 1996; Djankov and Murrell 2002; Makhija 2004). Having considered these circumstances, the fact that PRA in context of transition economies has not been studied yet is a significant omission.

### Traditional PRA Methodology

The traditional methodology of studies in the area of PRA is a survey method which employs questionnaires. Traditional surveys usually target only international firms to the exclusion of domestic (i.e. non-international) ones. The vast body of PRA literature suggests an approach to survey design demonstrated in Figure 1 (p. 5). The practices of PRA are usually examined in terms of the analysis being employed in the assessment process, its frequency, sources of information and the use of PRA output in decision making and mitigation of political risk. The whole process is normally studied as a firm-level specific concept which is defined by various firm-specific determinants; namely: size (Hashmi and Baker 1988; Stapenhurst 1992; Kettis 2004; Al Khattab et al 2008), level of internationalisation (Hashmi and Baker 1988; Hashmi and Guvenli 1992; Al Khattab et al 2008), ownership (Al Khattab et al 2008), and sector in which a firm operates (Stapenhurst 1992; Wyper 1995; Pahud De Mortanges and Allers 1996; Jenney 2001; Kettis 2004; Al Khattab et al 2008). Based on a literature on enterprise risk management (ERM) Benesova (2013) proposed that these determinants should be extended by firm complexity, location of subsidiaries, leverage, type of auditor, and firm's investment opportunities. This research design is summarised in a form of a diagram in Figure 1 below.

Figure 1: The Traditional PRA Survey Structure



Based on the model presented above, exploratory interviews were conducted with six Czech international firms and varying in all of the above mentioned firm-specific determinants. The process and results of these exploratory interviews together with their implications will be discussed in the following section.

## EXPLORATORY INTERVIEWS

Since the area of PRA has not been studied previously in the context of transition economies, and given the distinct managerial culture in post-socialist transition economies (Pavlica and Thorpe 1994; Dragomirescu 2012), exploratory interviews were conducted in order to determine the main patterns in political risk and its assessment. Unfortunately, it is not in the scope of this paper to provide detailed information on the methodology and design of the interviews; however the following two sections will briefly summarize the sampling method and data collection, and the results of the interviews.

### Exploratory Interviews: Sampling and Data Collection

In order to tentatively verify the results of previous studies<sup>1</sup> in the context of Czech Republic, six Czech firms which operate internationally were selected for interviews. Since this was an exploratory part of the research these firms were selected mainly on the basis of their experience in the international arena, their internal complexity, the nature of their business, and their size. The characteristics of the firms in the sample are presented in Table 1 below.

Table 1: Exploratory Interviews Sample

	<b>Number of Employees</b>	<b>Business Activity</b>	<b>Government Involvement<sup>2</sup></b>	<b>Operating Countries</b>
<b>Firm A</b>	49,000	Manufacturer of Consumer Goods	N/A	Global; Pakistan, India, China
<b>Firm B</b>	28,000	Manufacturer of Consumer Goods - Engineering	N/A	Global operations
<b>Firm C</b>	3,100	Manufacturer of glassware	Government-funded Projects	Middle East
<b>Firm D</b>	140	Manufacturer of Chemicals; R&D	40% of activities financed by governments	E.U. and U.S.
<b>Firm E</b>	60	Manufacturer of B2B chemicals	N/A	Eastern Europe, Middle East, Russia
<b>Firm F</b>	50	Manufacturer of Glassware Consumer Goods	N/A	U.S. and E.U.

A senior manager or – in case a risk management function was identified – risk manager was invited for semi-structured interviews. All managers who were contacted e agreed to discuss their attitudes towards and perceptions of political risk in their international business activities



as well as their PRA and political risk mitigation techniques. The data were collected over a period of one month in December 2012 and January 2013 by means of a discourse analysis, i.e. the semi-structured interviews were recorded for later analysis.

### Exploratory Interviews: Results and Implications

The output of the exploratory research suggests an extremely low standard of PRA. Although that this is in line with previous studies in the field of PRA, the PRA assessment function was non-existent in all the firms being included in the analysis. Having considered the geographical scope and headcount of the firms in the sample, this is a particularly interesting result. This was in spite of the fact that all interviewees expressed certain concern about various political risks which – should they occur – would cause major disruption to their activities as well as significant material and financial losses.

This result to some extent confirms the idea that managers might be resistant to the idea of political risk being amenable to analysis (Blank et al. 1980; Kobrin et al. 1980; Wyper 1995; Pahud De Mortanges and Allers 1996; Hood and Nawaz 2004; Al Khattab et al. 2008). It is certainly not possible to confirm Al Khattab's (2008) idea of lack of awareness of political risk in international business participants. However, an interesting pattern was identified which suggests that the majority of firms employ various mitigation strategies, ranging from purchasing insurance, through various risk reduction and risk transfer strategies to risk acceptance or rejection in case of more severe political risks. The only point at which firms indicated that a formal assessment of political risk in a host-country was undertaken would be at the stage of entering new countries. However, only three firms adopt PRA upon entering new markets; of which only "Firm B" employs official statistics in the analysis, the rest of the firms assessing political risk rely on subjective perceptions of PR in these countries, and the decision as to whether a new market should be entered or not tends to be rather intuitive than supported by some real output of a systematic analysis.

It can be concluded that the results of exploratory interviews indicate that the patterns of PRA in Czech international firms are to some extent consistent with previous studies conducted in this field (e.g. Rice and Mahmoud (1990), Hashmi and Guvenli (1992), Wyper (1995), Pahud De Mortanges and Allers (1996), Demirbag and Gunes (2000), Hood and Nawaz (2004) , Nawaz and Hood (2005), Agarwal and Feils (2007), Baas (2010) or Al Khattab et al. (2008)). However, the standard of PRA, although generally acknowledged as being low, has been much lower than reported by Rice and Mahmoud (1990), Agarwal and Feils (2007), Baas

(2010); Wyper (1995), Hood and Nawaz (2004); Hashmi and Guvenli (1992); Pahud De Mortanges and Allers (1996); and Al Khattab et al. (2008) in firms from Canada, U.K., U.S., Netherlands and Jordan respectively. Moreover, the PRA function in Czech international firms could be denoted as non-existent. Therefore the traditional concept of a questionnaire survey of practices of PRA in international firms does not apply to the Czech Republic. Thus, based on the interviews, a new approach to the structure and design of questionnaires needs to be proposed. The following section will discuss the possibility for a PRA survey in Czech international firms.

### PRA in the Czech Context: A Survey Dilemma

Based on the exploratory interviews conducted in Czech international companies an issue has arisen in relation to the current survey design. The traditional survey into PRA suggests that PRA is conducted in firms in order to adopt various mitigation strategies and diminish the possibility of various losses in case of a political risk occurring. The rationale behind the PRA function in a firm is that it should be incorporated within firm's risk management, i.e. it should be linked to all risk assessment, risk management, decision making under risk and risk mitigation (Davies and Walters 1998; Krause 2006; Sharp and Brock 2012). According to Krause (2006), the ideal way of dealing with risk would be to identify the various risks stemming from country of operation and its business environment, and consequently take these risks into consideration in the decision on the adoption of a strategy for operating in the particular country.

Given the specific Czech context, which – based on exploratory interviews – seems to be different from that of other countries a new approach to designing the research and the structuring of research tools needs to be developed. Since the majority of firms from this region seems to operate internationally and not to assess formally possible political risks stemming from their operations, it is desirable to explore the cause of this phenomenon. Additionally, given that the majority of firms have explained that they ‘... do not assess political risk because we have various mitigation tools to avoid it in the first place ...’<sup>3</sup>. Therefore it is desirable to design the survey in such manner that it would provide information on various strategies employed by firms in their international business activities linked to the specific political risks stemming from host-country environments. The following section presents a novel survey structure which can be used in the context of Czech international

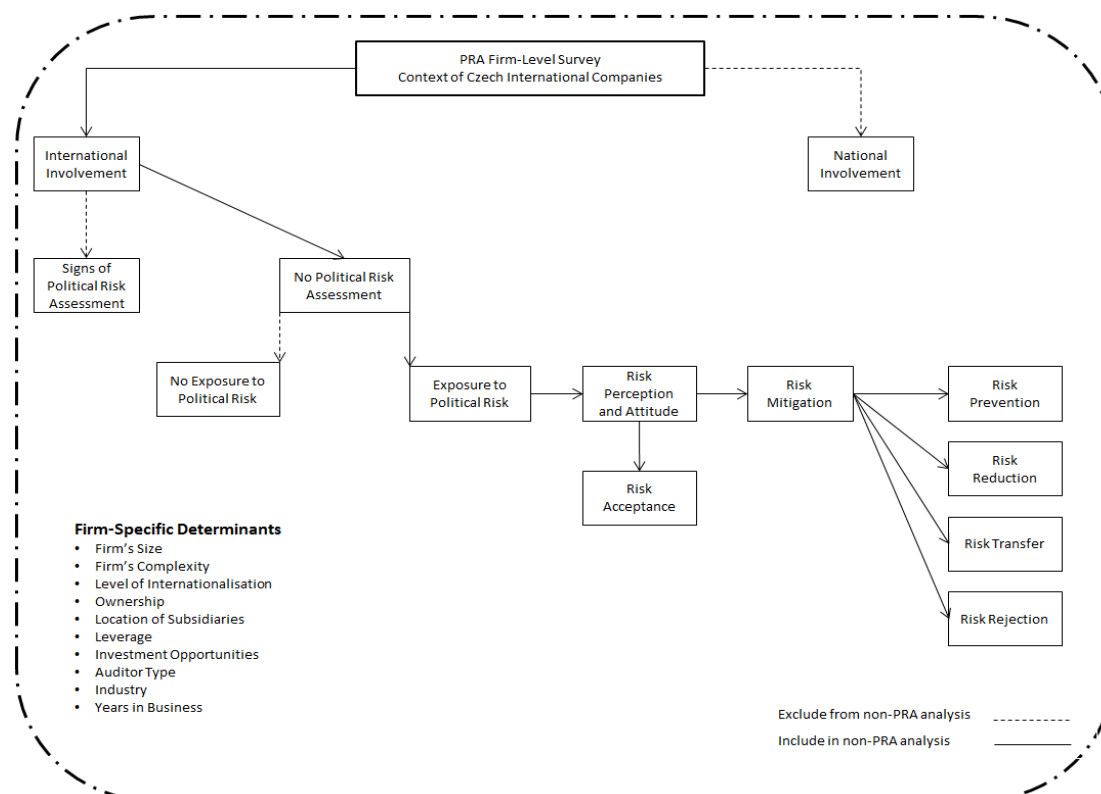
firms and by extension in international firms from countries with an extremely low standard of PRA or a non-existent PRA function.

### Research Consequences of Attitude of Czech Firms towards PRA

As already mentioned above the main purpose of this paper is to determine further possibilities for a PRA survey among Czech international firms in cases where a firm being a PRA user will not be an option as it is the most likely outcome based on the exploratory research. This, however, is by no means a reason to terminate the research. On the contrary, this result should be considered as a call for change in the traditional objectives of PRA studies which examine the characteristics and use of the PRA function. Given that the odds of a PRA function being non-existent are relatively high it is important to examine this phenomenon in greater detail.

As the results indicate, it is necessary to identify various mitigation strategies which firms adopt in order to decrease the impact of consequences of political risks should they occur. These mitigation strategies will allow the researchers to determine to what extent do these strategies, techniques and tools influence the decision of firms not to adopt a PRA function. The concept of such a survey design is demonstrated in Figure 2 below.

Figure 2: PRA Survey Structure in Czech International Firms



Five general strategies of dealing with risk have been identified; namely risk prevention, risk reduction, risk transfer, risk acceptance, and risk rejection. The latter two have a specific relationship with political risk itself as the first one, risk acceptance, suggests that a firm would accept all risks stemming from the host-country without further dealing with them; on the other hand a firm adopting the risk rejection strategy would reject to enter a country a priori for various context-specific reasons (Haughey and Bychuk 2011; Lynch 2012). Therefore, these two strategies will not be particularly informative in terms of the PRA function as these are definite in their nature. However, the remaining three: risk prevention, reduction and transfer can be further developed and employed in the study of the low standard of PRA and PRA mitigation in the context of Czech international firms.

Since it is not the purpose of this paper to discuss these mitigation strategies further, these strategies will not be mentioned in greater detail at this stage. The main purpose of this section was present a novel approach to a survey design which was fulfilled and summarized in Figure 2. The methodology together with the research limitations are discussed in the following section.

## **RESEARCH METHODOLOGY, CONTRIBUTION AND LIMITATIONS**

For purposes of this research only international firms will be targeted, to the exclusion of domestic (i.e. non-international) firms. This delimitation does not mean that domestic firms are not vulnerable to political risk in the home country. The focus on international firms, however, aims to achieve consistency with the majority of the literature in which exposure to political risk in its many forms is a consequence of undertaking international business activities. This focus was also justified by Eiteman et al. (2000), Kettis (2004), Hood and Nawaz (2004) and Stosberg (2005) who argued that political risk is a special dimension of risk that an international firm has to deal with, in addition to the traditional risks associated with business activity in the home country.

The focus on Central Europe will enable an exploration of how international firms from transition countries perceive and assess political risk and an assessment of the reasons for any divergent approaches to political risk assessment (PRA) which may be identified. In the same vein, it will be possible to undertake a comparison between the findings in the context of Central European firms and those findings in different geographical contexts. Since earlier studies also targeted firms from one nationality operating in different countries, a comparison is feasible.

Given the nature and the scope of the study, there are obviously some limitations that need to be pointed out. First of all due to limited time and resources not all firms will be employed in the survey, i.e. it would not be a census-type of survey. This could cause the exclusion of firms which assess political risk in their international business; however, since the selection of firms invited to participate in the survey would be random in its nature, it is expected to exclude many firms. Another limitation of this study is that it does not examine the home-host country political risk relationship, and therefore it does not answer various methods of transfers and/or sharing of risk in this context.

## **CONCLUSIONS**

The main purpose of this paper is to present a novel approach to designing survey research in the area of political risk assessment in international firms. Based on the results of exploratory interviews an interesting pattern in the practices of managers from Czech international firms was identified which needs to be considered in studies of PRA in the context of countries where PRA in international firms is either extremely low, or non-existent. After consideration of the current attitudes of Czech managers towards political risk and their risk mitigation practices a model that would explain the cause of the low standard of PRA has been developed. This model uses various strategies of risk mitigation which can be adopted by firms. This is a significant contribution, given that the adoption of various mitigation strategies has been considered as a justification for abandoning the PRA function in the majority of firms. This research model can be used not only in a Czech-specific context but certainly in research aimed at international firms from economies with similar characteristics, and therefore will be suitable mainly for studies of firms from post-socialist transition economies.

## **NOTES**

<sup>1</sup> Studies which were taken into consideration were those of Rice and Mahmoud (1990), Hashmi and Guvenli (1992), Wyper (1995), Pahud De Mortanges and Allers (1996), Demirbag and Gunes (2000), Hood and Nawaz (2004), Nawaz and Hood (2005), Agarwal and Feils (2007), Al Khattab et al. (2008), and Baas (2010).

<sup>2</sup> All firms are eventually involved with governments and therefore affected by the political environment in the countries of operation; however this column indicates direct financial dependence on governments themselves.

<sup>3</sup> Please note that this is a short transcript from an interview with management in “Firm B”.

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